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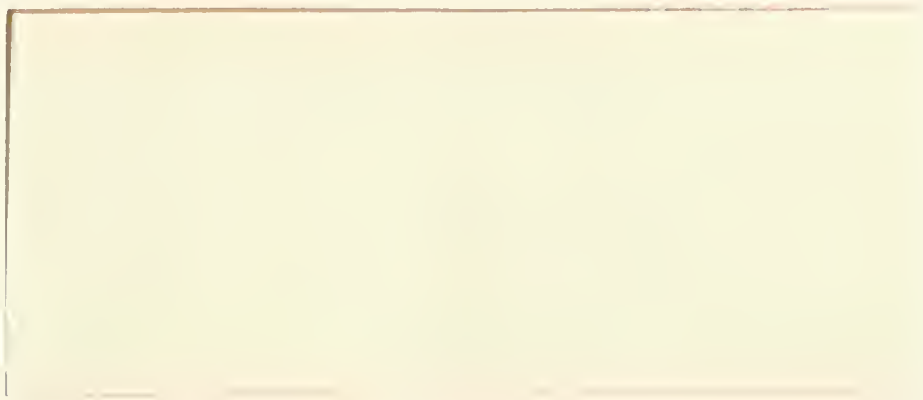
ORGANIZATIONAL FORMS

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Working Paper No. 3468-92BPS

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## ORGANIZATIONAL FORMS

As researchers begin to focus on organizational forms beyond the conventional types of hierarchy and market, we argue that such efforts should be predicated on theoretical considerations that complement the transaction cost model. We develop an integrative framework to understand four organizational types--markets, hierarchies, inter- and intra-organizational networks--based on four underlying types of 'cost': bargaining, influence, management, and transaction. We illustrate the framework by discussing how a relevant set of management themes--vertical integration, corporate diversification, and multi-national entry strategies--might be better understood as resulting from the interactions of these four types of cost, and discuss implications for future research.



## INTRODUCTION

Strategic management is concerned with the scope of the firm: namely, the articulation of the tasks that would be carried out under the firm's control. This theme, in its various forms, has been fundamental to classic writings (Selznik, 1959; Chandler, 1962; Ansoff, 1965; Andrews, 1971) and has served as an underlying logic to the inductive (case study) orientation in early strategy research (see, for example, Schendel and Hofer, 1979). Over the years, this theme has been reflected in such important streams of inquiry as corporate diversification (for example, Ansoff, 1958; Morris, 1958; Wrigley, 1970; Rumelt, 1974; Bettis, 1981), vertical integration (for example, Walker and Weber, 1987; Caves and Bradburd, 1988), and joint ventures (for example, Harrigan, 1988; Contractor and Lorange, 1988).

Recently, this theme has gained greater importance with the recognition that the scope of the firm has undergone significant changes toward less conventional types, to include activities conducted through a complex array of formal and informal alliances and partnerships. These less conventional organizational forms have been variously conceptualized as clans (Ouchi, 1980), hybrids (Williamson, 1991), and networks (Miles and Snow, 1986; Thorelli, 1986; Powell, 1990; Jarillo, 1988), and are sometimes seen to be within the continuum between hierarchy and markets (Williamson, 1985), and sometimes not (Powell, 1990).

Although the scope of the firm is a fundamental theme in strategic management, deductive research efforts have been constrained by a lack of an underlying integrative theoretical framework. Much of the research efforts have been built upon a convenient set of constructs borrowed from related literature; comparability of inferences across the studies

is rendered difficult since different studies use different implicit assumptions to characterize (i) the scope (and goals) of the firm; (ii) managerial behavior within the firm, and (iii) the environment in which the firm operates. Where systematic theorizing does exist, the logic of transaction cost economics (TCE) (Coase, 1937; Williamson, 1975; 1985) appears to have provided the major intellectual anchor (see, for example, Barney and Ouchi, 1986; Walker, 1988; Walker and Weber, 1984; Walker and Poppo, 1991; Hill, 1990; Hennart, 1991; Osborn and Baughn, 1990; Kay, 1992).

However, the reliance on TCE as the basic explanator of organizational forms raises two troubling questions. First, organizations are, for the most part, seen as responses to failures of the price mechanism (Coase (1937: 389)). Even here, certain core constructs--notably asset specificity--are seen as the key determinants of organizational forms. A question that can then legitimately be raised is: could there be a logic for organizations that is independent of the core TCE constructs? Second, TCE does not explicitly allow for the possibility--a presumably logical one--that contractual structures that are similar to market forms could arise as a response to failures of organizational forms. This raises the question: could there be a logic for markets that arises from organizational failures? We shall argue in this paper that the answer to both questions is "yes," and then explore the implications of this assertion.<sup>1</sup>

While the TCE framework has been instrumental in characterizing the polar ends of a continuum of markets and hierarchies, it needs to be complemented with other

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<sup>1</sup> The latter question is one that is implicit in a great deal to research in the organizational sciences. Just as economists have rarely felt the need to question the rationale for the existence of markets, organizational scientists (as the term itself suggests) have rarely needed to question the rationale for the existence of organizations. Chandler (1992: 79), for example, recently noted: "As a historian who has spent a career in examining the operations and practices of business firms, I have not given much thought to precise definitions of the firm. I have had little trouble locating information on literally hundreds of individual enterprises."

perspectives if the less conventional organizational forms such as clans and networks are to be understood neither as “discrete structural alternatives” (Williamson, 1991) nor as organizational forms distinct from either markets or hierarchies (Powell, 1990). Specifically, our purpose in this paper is threefold. One, we intend to develop an integrated theoretical framework that complements TCE to explain four generic organizational forms: markets, hierarchies, inter-, and intra-organizational networks. In order to do so, we consider other costs associated with governance structures: bargaining and influence costs (Milgrom, 1988; Milgrom and Roberts, 1988; 1991), and management costs (Coase, 1937; Demsetz, 1988), all based on a set of behavioral and environmental assumptions that are consistent with those of the TCE logic. Two, we illustrate the power of our framework in explaining a set of three current and important strategic management themes. Three, we discuss the descriptive and predictive validity of our proposed framework.

#### BUILDING BLOCKS: COSTS OF ‘MARKETS’ AND ‘ORGANIZATION’

We begin with the observation that TCE by itself is limited in its ability to explain the breadth of organizational forms in the continuum of markets and hierarchies. We do not intend to develop any detailed critique of TCE research since such discussions are already available (for example, Granovetter, 1985; Robins, 1987; Eccles and White, 1988; Perrow, 1990; Kay, 1992). However, two observations are worth noting. The underlying logic of TCE is fundamentally based on understanding the governance and contracting implications of *market* failures—in other words, the firm arises as a response to the costs of undertaking exchanges in markets.<sup>2</sup> Costs associated with firm-like governance forms (and hence the market contracting arising as a response to *organizational* failures) are rarely

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<sup>2</sup> Coase (1937: 389) notes, for example that, “...the distinguishing mark of the firm is the supersession of the price mechanism.”

addressed in any depth. Second, even in understanding the firm as a consequence of market failures, we shall argue that a dominant construct in TCE--namely, asset specificity--is a sufficient, but not necessary condition for the emergence of the firm.

Instead, we aim to develop a broader conceptualization of costs of governance in terms of *market* costs and *organization* costs. Specifically, market costs are the aggregation of *transaction* costs as traditionally defined, and, in addition, *bargaining* costs that result from failures associated with reaching efficient market-mediated agreements; organization costs are the aggregation of *influence* costs and *management* costs resulting from failures associated with efficient decision-making in hierarchies. Our basic argument is this: *four basic types of organizational form--markets, hierarchies, intra-, and inter-organizational networks--can be better understood as a result of the trade-offs between market costs and organization costs, rather than in terms of only transaction costs.*

In what follows, our underlying assumption of the goal of the firm is that of profit (or market value) maximization. This assumption, while limited perhaps in explaining observed managerial behavior, is one that is consistent with the frameworks (including TCE) underlying the development of our theory.

### *Market Costs*

*Transaction Costs:* Under the behavioral assumptions of opportunism and self-interest maximization, and environmental assumptions of information asymmetry, small numbers, and uncertainty, TCE argues that transactions (defined to be transfers of goods and services across a "technologically separable interface" (Williamson, 1975)) in market settings may be prone to friction, resulting in transaction costs.<sup>3</sup> These costs are characterized by

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<sup>3</sup> Our focus in this paper is primarily with the "asset specificity" branch (Williamson (1989: 149)) of TCE. Some scholars have noted that there is another strand of TCE--the so-called "measurement" branch--which relies primarily on the roles of information asymmetry and costs of



three essential attributes: (a) asset specificity (i.e., the extent to which an asset can be redeployed to alternative uses and users without loss in value); (b) frequency of interaction; and (c) uncertainty. Of these three, asset specificity is accorded the most explanatory power. For example, Williamson (1988:72) notes that, "...although all (three) are important, many of the refutable implications of transaction cost economics turn presently on the last (asset specificity)."<sup>4</sup> The greater the asset specificity, or the higher the frequency of interaction, or the greater the uncertainty, then the greater the transaction cost. If the cost of undertaking such transfers through markets exceeds the costs of undertaking them within the hierarchy, then parties to the transaction will have the incentive to internalize such transactions. The prediction of the theory is that we are likely to observe particular types of governance structures (for example, multidivisional or unitary forms of organizational structure, or make versus buy decisions relating to vertical integration) as being the outcomes of particular forms of the transaction cost-minimizing motive. An important attribute of hierarchies is that of selective intervention--the idea being "...to replicate the market mode within the firm in all respects save those where intervention is the source of expected net gains (Williamson (1992: 339))." Further elaboration of these concepts can be found in Williamson (1975; 1982; 1985; 1990; 1991).

*Bargaining Costs:* These are, fundamentally, costs associated with failures to reach efficient agreements--or, coordination failures--in market settings (Milgrom and Roberts, 1991). There are many instances in which market forms of exchange fail even when critical

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information acquisition (see, for example, Alchian and Demsetz (1972); Barzel (1982)). Though we consider the importance of costly information acquisition in our discussion of bargaining costs and management costs below, our framework is only tangentially based on the latter branch.

<sup>4</sup> This point is not only recognized by Williamson, but also by critics of the theory (see, for example, Kay (1992: 316)).

attributes such as asset-specificity are not present. A classic example would be the bilateral monopoly problem: it is well-known that there may be many or no self-enforcing agreements when both parties to a contract have monopoly power, or even if there were, the outcome of the agreement could be indeterminate (Nash, 1950). Even if market-mediated agreements can be reached, they may not always be the most efficient outcomes. This can be seen in the single-period prisoners' dilemma game, where, even under conditions of full information, non-cooperative behavior results in an outcome that is inefficient to both parties (e.g., Shubik, 1983).

Moreover, even if there were agreements and there were no failures to reach the efficient agreement, there may still be information acquisition costs and enforcement costs. This is because parties to the agreement may expend socially excessive amounts of resources in acquiring information on relevant bargaining attributes, and in enforcing the agreement. Finally, there are also direct costs associated with compensating parties to the bargain and with the time spent in bargaining (Milgrom and Roberts (1991)). Thus, when there is the likelihood of coordination failures, or possibilities of excessive expenditure on information acquisition, or high direct costs of bargaining, centralized coordination in a hierarchy through authority imposed on parties to the contract might be preferable to leaving such transactions to markets.

In summary, market costs are the aggregate of bargaining costs and transaction costs (as defined above). Bargaining costs can arise independent of asset-specificity. While asset-specificity is a sufficient condition that favors hierarchical modes of governance, it is not a necessary condition. Market contracting can fail and hierarchical contracting become necessary when bargaining costs are high. Efficient market contracting would, in our framework, require that there be no asset-specificity, *and* that there be low bargaining costs.

### *Organization Costs*

In this section, we shall argue that there are certain costs that are intrinsic to governance forms that are hierarchy-like: influence costs and management costs. A basic idea underlying TCE (and the emergence of effective hierarchical governance structures) is Williamson's notion of 'selective intervention' implying that "each production stage is directed to perform in the preacquisition manner except when misalignments occur and the substitution of authority for autonomy yields net gains (Williamson, 1988: 78)." If higher levels of authority have the option to selectively intervene, then it must be possible for a large firm to do at least as well as a smaller firm, since the manager has the option of leaving the organizational subunits autonomous. Though Williamson allows for the possibility that selective intervention can break down (e.g., he notes that asset dissipation, loss of incentive intensity, and added latitude for politicking are sometimes likely in hierarchies; Williamson (1985: Chap. 6; 1992: 339)), the arguments are by no means as fully developed as those pertaining to market failures. Indeed, our objective is to examine precisely this issue in greater depth.

*Influence Costs:* Based on a set of constructs developed in the political economy and public choice literature (for a review, see Noll, 1989), Milgrom (1988) and Milgrom and Roberts (1988; 1991) conceptualize these as costs that are intrinsic to hierarchies.<sup>5</sup> These arise whenever organizations have to expend resources to combat incentives for *redistribution and reduction* of value, rather than its *creation* (see also Becker (1985)). Incentives for value redistribution and value reduction in hierarchies are fundamentally the consequence of three factors. First, there may be a mismatch between the importance of an activity to the

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<sup>5</sup> The terminology "influence" as associated with bureaucratic forms of organization is perhaps originally due to Becker (1983).

organization as a whole (which may be low), and its distributional consequences at the level of organizational subunits (which may be high). Such settings provide organizational subunits the incentive for value redistribution rather than value creation, since benefits are concentrated at the subunit level while costs are dispersed organization-wide. This argument can be best seen in Allison's (1971) discussion on the role of parochial priorities (relative preferences and influence of the different subunits vying for distinct decision outcomes) in impacting the final decision.

Second, there is the possibility (indeed, a high probability) of inappropriate or inefficient forms of selective intervention by higher levels of authority that may arise for at least two reasons: (a) embedded in the concept of hierarchical structures is the notion that higher levels of authority can intervene, but are themselves relatively insulated from intervention (Milgrom and Roberts (1991)), and (b) it is inherent in the nature of hierarchical decision-making that higher levels in the firm have to rely upon interested parties (i.e., lower levels in the firm) for the provision of information that leads to decisions; that is all *data come from those who have the incentive to provide it*. This provides an incentive for information-filtering that would affect the quality of decisions that higher levels of authority will make (Milgrom and Roberts, 1986).<sup>6</sup> This is consistent with Allison's (1971) treatise on information asymmetry and filters within the organization. He highlights, in the context of the Cuban missile crisis, how information made available by different parties (subunits) sought to present particular parochial

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<sup>6</sup> The notion of information filtering is similar to insights that appear in a large body of organization theory in relation to "impression management" (Goffman, 1959; for a review across diverse issues such as organizational failure, business ethics, leadership, and career strategies, see Giacalone and Rosenfeld, 1989). This literature examines the organizational implications of the concerns of people and decision centers to make positive impressions on others, with a view to construct and manipulate their organizational identities and their power--in other words, to enhance their influence.

positions rather than be guided by the notion of an “objective” information set for a given decision-context. Third, there is the likelihood of rent-seeking behavior (Tullock, 1967; Krueger, 1974) that is associated with all bureaucratic forms of mediating exchange; whenever there are rents to be distributed, there is an incentive for distributional conflicts between parties who have access to such rents.

*Management Costs:* Coase (1937: 395) originally suggested that there may be costs that arise from diminishing returns to management. First, as the firm grows larger, the entrepreneur may fail to place the factors of production in uses where their value is greatest. Second, the supply of factors of production may not be linear in firm size; that is factors of production may charge a price that more than nullifies the benefits of decreased costs resulting from increased firm sizes. Third, efficiency will decrease with increases in the spatial distribution and heterogeneity of transactions, both of which are likely to accompany increased firm sizes.

All three types of cost could be argued to arise from diseconomies in the knowledge-processing ability of firms (or in the words of Chandler (1992: 83), the limitations of “organizational capabilities”). Demsetz (1988) used the phrase “management costs” to describe the inefficiencies that arise in this organizational knowledge processing ability. He argued that three attributes characterize hierarchical authority: (a) *specialization*, or the production of goods and services mainly for persons who are not members of the firm’s team; (b) *continuity of association*, where the firm viewed as a team production exhibits significant reassociation of the same input owners, and (c) *reliance on conscious direction* that is used to guide the uses to which resources are to be put. All three attributes of hierarchical coordination require the creation, use and transfer of knowledge.

Clearly, specialization implies the creation and use of unique knowledge through

the development of "practiced organizational routines" (Nelson (1991: 67-68)); continuity of association and reliance on conscious direction implies that such knowledge must be transferred through a hierarchy of such routines. The larger the firm, the greater the need for the creation, use and transfer of knowledge; ultimately, according to Demsetz (1988: 159), the vertical boundaries of the firm are determined by the "...economics of conservation of expenditures on knowledge."

In summary, organization costs are the aggregate of influence costs and management costs. The presence of influence costs can result in inappropriate or inefficient forms of selective intervention, thus weakening the logic for hierarchies. In addition, even if influence costs were not present, the economics of conservation of expenditures associated with the creation, use, and transference of knowledge, and diminishing returns to management (management costs) may delimit the effectiveness of the hierarchy as an organizational form. Hierarchical modes of contracting not only require that selective intervention be efficient and influence costs low, but also that management costs arising from the creation, use, and transference of knowledge be low.<sup>7</sup>

Table 1 summarizes the arguments that we have developed, by listing the variables

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<sup>7</sup> In developing our ideas above, we may appear to have overlooked a large body of insights that have made their way into organizational sciences from agency theory. We have consciously done so, for two reasons. First, the underlying assumptions of both TCE and agency theory are similar (e.g., the equivalence of the notions of moral hazard in agency theory and opportunism in TCE, the commonality of the role of uncertainty, and the prevalence of asymmetric information and incomplete contracting); consequently, many of the predictions that agency theory would make are similar to those from a TCE perspective. To the extent that TCE includes additional explanatory variables such as asset-specificity, we believe that it is capable of greater explanatory power from an organizational sciences standpoint. Second, agency theory is equally at home in explaining market contracting behavior (e.g., Jensen and Meckling (1976) or the vast literature in relation to insurance markets from where the concept of moral hazard arose) as it is behavior within the hierarchy (e.g., Holmstrom, 1979; Holmstrom and Ricart i Costa, 1986; Demski and Sappington, 1984; 1986; Eisenhardt, 1989). Consequently, it is less capable of distinguishing among the various organizational forms in the predictions it would make. Our intention is to provide a finer partition of issues--both beyond TCE and agency theory--that would lead to better predictions of particular types of organizational form.

influencing market and organization costs.

(Insert Table 1 About Here)

### OUR FRAMEWORK

Based on the discussion above on market and organization costs, we develop a framework to specify four distinct organizational forms: hierarchy, markets, inter-organizational networks and intra-organizational networks (see Figure 1).

On the assumption that markets and hierarchies are two viable contracting forms, we have argued that *markets* emerge as the appropriate form only under conditions of high organization costs and low market costs; similarly, *hierarchies* emerge as an appropriate form only under conditions of low organization costs and high market costs.

While these two “pure” forms are diagonally positioned in our framework, the two other positions define alternative types of organizational form. First, given our arguments above, note that high organization costs would militate against the hierarchy as the efficient contracting form, just as high market costs would militate against markets as the efficient contracting form. When the context is high/high, therefore, the efficient form would involve an inter-organizational network (e.g., long term contracting arrangements, R&D partnerships, joint ventures). Our reasoning is as follows: an inter-organizational network would mitigate bargaining costs of markets by quasi-internalizing the transaction; on the other hand, it would mitigate management costs since the creation, use, and transference of knowledge would not have to be left to markets where appropriability problems would be high (Klein, Crawford and Alchian, 1978).

Similarly, when the context is low/low, by definition, transaction, influence, management, and bargaining costs are low. This context, in turn, would be one where relationship embeddedness and socialization as means of control can play a role in

economic exchange--the appropriate organizational form here would be the intra-organizational network. This organizational form is distinguished by relationships characterized by embeddedness, and rely upon socialization (and other non-formalized means) as mechanisms of control. The reasoning is that, on the one hand, internalization can substitute authority for autonomy and allow for socialized mechanisms of control (because of the low organization costs); on the other hand, low market costs enable embeddedness to replace bargaining costs and problems resulting from the hazards of opportunism that would lead to transaction costs.

(Insert Figure 1 About Here)

We now illustrate the explanatory power of our framework using three themes that have been chosen to reflect their centrality to current strategic management research: (a) determinants of vertical integration; (b) patterns of corporate diversification,<sup>8</sup> and (c) entry strategies of multinational enterprises (MNEs).

#### *Determinants of Vertical Integration*

Research on vertical integration spans several disciplinary perspectives. Arrow (1975), for example, contends that higher levels of uncertainty in the supply of the upstream good and higher need for information by the downstream firm will both be associated with increased levels of vertical integration. In the organization sciences literature, vertical integration is seen as a rational response to uncertainty. For example, Thompson (1967) argues that firms that rely on long-linked technologies (i.e., interdependence in successive stages of production) are more likely to have higher levels of vertical integration, especially

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<sup>8</sup> Some might argue that vertical integration is simply another form of corporate diversification, and that both sets of activity seek to expand the scope of an organization. Our separating the two doesn't necessarily disagree with this viewpoint, but simply seeks to highlight two research streams that have existed independent of each other.



under conditions of high uncertainty.

The dominant theoretical perspective for the research on vertical integration, however, is TCE (Williamson, 1985; 1989). The key notion here is that behavioral conditions (bounded rationality and opportunism) combine with environmental conditions (small numbers exchange, uncertainty, and information asymmetry) in the context of asset specificity to create high market transaction costs. In essence, the central thesis is that vertical integration is an efficient governance response when spot market contracting is prone to failures. Thus, in terms of Figure 1, TCE addresses two diametrically opposing positions (top right and bottom left), and is less concerned with the low/low and high/high contexts of markets costs and organization costs.

While there has been general empirical support for the TCE logic (Monteverde and Teece, 1982; Masten et al, 1989; Walker and Weber, 1984), extant empirical observations cannot be used to discount the possibility that other competing perspectives such as those discussed above in this paper (bargaining, influence and management costs) could be equally powerful, if not better, predictors of vertical integration. Milgrom and Roberts (1988; 1991) argue that the management practice of spinning off unprofitable subsidiaries can be partly interpreted as an action designed to prevent the employees and management of these subsidiaries from imposing large influence costs on the organization by trying to claim corporate resources to cover their losses rather than become efficient. The implication is that influence costs could predict a reduction in the level of vertical integration regardless of the levels of asset specificity, uncertainty or frequency of transactions. Researchers, however, have not tested such arguments against the traditional TCE postulates.

Our contention is that influence costs could predict a reduction in the level of vertical integration regardless of the levels of asset specificity, uncertainty, or frequency of

interactions. The movement away from spot contracting to less-than-complete integration (e.g., vertical alliances) could be predicted by increasing levels of bargaining and transaction costs, for a given high level of organization costs. The reasoning here is that, while the market costs would favor some form of internalization, the high organization costs would militate against complete internalization by vertical integration, thus arguing for quasi-internalization through a vertical alliance.<sup>9</sup>

Similarly, there would be a movement away from complete internalization through vertical integration toward some form of *long-term* contracting with buyers and suppliers when influence and management costs are low, but levels of transaction and bargaining costs vary. The reasoning here is that, while the low market costs would favor some form of market-based contracting, the absence of high organization costs would make possible longer term relationships (recall the Thompson observation about long-linked technologies in the presence of uncertainty). Again, we see (at least anecdotally, as reported in various trade periodicals) the increasing prevalence of long-duration contracts with vertical partners in many industries.

Thus, traditional TCE-based tests of vertical integration as a response to market failure may neither be complete nor fully identified in terms of their explanatory power. For instance, Walker and Poppo (1991) sought to examine whether organizations and markets govern transactions differently, and conclude that they do, with a qualified yes. They note: "..... a conventional test of transaction cost theory which compares the level of asset specificity inside and outside an organization would fail" and further that "hybrid

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<sup>9</sup> We see this trend in several industries, where organizations such as General Motors and IBM are not just positioning themselves in a markets-hierarchy continuum anymore, but have resorted to vertical alliances because of perceived high organization costs (e.g., the GM-Toyota alliance, or the IBM-Apple Computer alliance).

organizations and markets are more similar than transaction-cost theory proposes. Moreover, because in-house and market supply have the same level of interunit conflict, a process of institutional selection based on transaction costs would not favor one type of supplier over the other." (p. 82). These observations are consistent with our arguments that a finer empirical assessment adopting the four-part classification of costs we propose may be necessary to discern the competing choices.

More recently, research in the TCE vein has sought to expand the domain of what constitutes asset specificity, by bringing in newer dimensions that reinforce our framework. For example, Masten et al (1991) derive a construct termed as temporal asset specificity (see also Williamson, 1991: 281-282). They argue that in tightly-linked production systems, an opportunistic supplier may threaten to suspend supplies at the last minute in order to extract a greater share of the return from the buyer. Thus, although there may not be high levels of specificity in the skills and assets necessary to supply the required parts, the buyer may be forced to arrange an alternative supplier on short notice. This introduces the prospect of strategic holdups, which they label as temporal asset specificity.

We argue that this conceptualization of asset specificity is closer to the concept of bargaining cost rather than asset specificity. The reasons are as follows. First, temporal asset specificity is implicitly used as a construct that is independent of traditional notions of asset-specificity (i.e., they are sufficient, but not necessary, for temporal asset specificity); consequently, it could arise even when other (more traditional characteristics) of asset specificity are not present. Second, Masten et. al. describe this construct as portraying three characteristics between the supplier and the buyer: rents (implying small numbers), strategic behavior (implying non-price taking behavior), and costs associated with substitutes

(implying an incentive for single sourcing), leading to the observation that the description is closer to the Milgrom and Roberts (1991) characterization of a bilateral monopoly problem than a competitive contracting process.

Thus, while vertical integration can be explained through TCE-based concepts such as asset-specificity and uncertainty, bargaining costs could play an important role independent of transaction costs in arguing for internalization; in addition, influence and management costs are likely to be important determinants of the limits to vertical integration.

We summarize the arguments in Proposition 1A and 1B.

*Proposition 1A: When organization costs are high and market costs are low, we are likely to observe reliance on market-exchange through spot contracting relationships; similarly, when organization costs are low and market costs are high, we are likely to observe a greater degree of vertical integration.*

*Proposition 1B: When both organization costs and market costs are low, we are likely to observe market-like contracting with long-term vertical relationships; when both organization and market costs are high, we are likely to observe the formation of inter-organizational vertical alliances.*

### ***Patterns of Corporate Diversification***

Despite vast amounts of research on corporate diversification (for reviews, see Ramanujam and Varadarajan, 1989; Hoskisson and Hitt, 1990; Logue and Sundaram, 1991), a complete theory of why firms diversify (when investors can), and why they choose particular types of diversification (related versus unrelated versus conglomerate; Wrigley, 1970; Rumelt, 1974) remains elusive. If the objective of shareholder value maximization (equivalent to profit maximization) has some validity--at least as a first approximation to

managerial behavior--then *corporate* diversification would be, at best, a neutral mutation (and, at worst, value reducing) when investors in well-functioning capital markets can diversify relatively costlessly (Logue and Sundaram, 1991). Yet, stylized wisdom in the strategic management literature argues that not only do we observe corporations spending tens of billions of dollars annually in order to diversify, but on balance, related diversification outperforms unrelated diversification. One rationale that has been offered, in the TCE vein, revolves around the role of complementary and shared assets. However, Kay (1992: 326) notes that TCE has been less than useful in explaining forms of diversification other than conglomerate diversification.

Our framework helps provide a more complete explanation of not only degree, but also of type, of corporate diversification, thus narrowing the gap between strategic management and finance-theoretic viewpoints.

We start with the observation (see also Williamson (1985: 154-178)) that if corporations are undertaking an activity that investors could have, they are by definition *internalizing* an activity that could have been left to markets. In the TCE framework, if a firm perceives a high degree of asset-specificity and expects that it has the ability to selectively intervene efficiently, then it would have the incentive to internalize its diversification activity. However, this raises a puzzle (analogous to the more general issue that Coase raised): if solely the TCE explanation were true, we should expect investor, rather than corporate, diversification to be anomalous. Further, while the TCE framework might provide a rationale for internalization of diversification *per se*, it does not explain *types* of diversification. The explanation may lie in the impact of management and influence costs.

First, not all diversification will be efficiently undertaken by corporations, since, as

we have previously argued, there are management and influence costs associated with internalization. When these are high, such activity would be more efficiently transacted in markets rather than hierarchies (bargaining costs are relatively unimportant in well-developed capital markets, since the market for the good under exchange (i.e., proxies for ownership, such as shares) are characterized by a large number of participants, high liquidity, prevalence of close substitutes and publicly observed and traded prices, all transacted under regulatory surveillance). Thus, while TCE provides a logic for internalization of diversification, management and influence costs explain the limits to internalization, providing an argument for *degree* of diversification.

Second, turning to *types* of diversification, we contend that related diversification can be expected to outperform unrelated diversification since management and influence costs will be lower with related diversification. Firms undertaking related diversification do so by extending their core skills and capabilities: put simply, they know the business they are entering into (Rumelt, 1974; Chandler, 1992). In the process, knowledge transference costs will be lower, thus minimizing management costs. Further, since related diversifiers would transfer capabilities and resources that they already have familiarity with, there is less of a problem of reliance on the information of interested parties (i.e., the acquired firm if the diversification is by acquisition, and the sellers of factor inputs if the diversification is by building *de novo*). Third, the related diversifying firm would have a greater ability to appropriate rents from the diversification, since they result from extensions of the firm's existing capabilities and knowledge base (Chandler, 1992). The latter two reasons would serve to reduce influence costs associated with internalization and thus increase the quality of selective intervention (for the reasons argued earlier). In the aggregate, therefore, we would expect related diversification to outperform other types of corporate diversification.

We summarize our arguments in Propositions 2A and 2B:

*Proposition 2A: When market costs are low, corporate diversification is unlikely to add value. In addition: (i) if organization costs are low, we are likely to observe conglomerate diversification; (ii) if organization costs are high, corporate diversification is likely to be value-reducing.*

*Proposition 2B: When market costs are high, we are likely to observe corporate diversification. In addition: (i) if organization costs are low, we are likely to observe related diversification; (ii) if organization costs are high, we are likely to observe unrelated diversification.*

#### *Differentiated Entry Strategies by Multinational Enterprises (MNEs)*

Conventional theories of the MNE view entry abroad by firms as comprising three broad sequential stages (see, for example, Vernon, 1966; Calvet, 1981; Root, 1987): the *export* mode where the firm produces at home and sells abroad through direct or indirect sales channels, followed by *contractual* modes such as licensing and technical agreements, franchising, management contracts etc., and culminating in the *direct foreign investment (DFI)* mode whereby a firm establishes a joint or sole venture.

A dominant paradigm that explains what is seen to be the ultimate stage of evolution of the MNE is TCE (Buckley and Casson, 1976; Magee, 1976; Calvet, 1981; Rugman, 1980; Hennart, 1982; Teece, 1983). The TCE logic is that the MNE uses the hierarchy through direct equity involvement to produce and sell its output in situations in which arms-length contracting modes (export or contractual entry) are prone to failures. In particular, it is argued that the firm will internalize through the DFI entry mode when investment in knowledge-based assets such as technology, managerial skills, corporate culture/shared values, organizational structure, etc., result in high asset-specificity.

Yet, it has been observed that many firms appear to adopt entry strategies that do not follow the "stages" model. Further, it has also been observed that many MNEs appear to *simultaneously* pursue different entry strategies in different markets and products at any given time. Ghoshal and Bartlett (1990) observe, for example, that an MNE is perhaps better understood as a differentiated network of subsidiaries, with exports, contractual, and direct investment modes coexisting in different parts of the world. In other words, we observe *differentiated* entry strategies and modes of involvement by MNEs, an observation that is at variance with a dominant body of theory that suggests sequential stages of involvement. TCE is inadequate in explaining simultaneously different entry modes since the asset-specificity factors that favor internalization must be largely the same the world over. There has been considerable empirical research (see, for example, Rugman, 1982 and the various studies therein; see also Gomes-Casseres, 1989), but the support is mixed.

Sundaram and Black (1992) argue that one important determinant of differentiated entry modes is a distinguishing aspect of the MNE (as opposed to the non-MNE) environment: multiple sources of external authority, as embodied in the problem of country risk. Their arguments are as follows. In the presence of high degree of country risk, the firm would seek to minimize its asset commitments in the host country, given the greater likelihood of asset and cash flow vulnerability to the authority of the sovereign state. Therefore, when country risk is high in the country of foreign operations, the MNE is likely to choose export and contractual modes of entry; when country risk is low in the country of foreign operations, the firm is likely to choose the DFI mode of entry. Further, when country risks vary by location of foreign operations, an MNE's entry mode is likely to be different in different locations.

The relationship between the MNE and the sovereign state is akin to a bilateral



monopoly situation. The greater the country risk, the greater the likelihood that the legitimacy of the state can result in contract vulnerability once asset commitments are made, and the lower the likelihood that contracts are enforceable. Thus, greater country risk is likely to result in higher bargaining costs, militating against the direct investment mode. With high country risk, influence costs are also likely to be high for two reasons: (a) lower levels of decision-making in firm (subsidiary managers) derive an internal authority that is legitimized by local norms, laws, and culture; the greater the country risk, the greater such local legitimacy of the subsidiaries' authority; (b) compared to the domestic context, there is greater reliance on the information of interested parties in corporate decision-making; the greater the difference between home and foreign environments, the greater the likelihood of country risk, and thus, the greater the reliance on information provided by subsidiaries. The DFI mode of entry is likely to be particularly vulnerable to influence costs, since theory tells us that one of the important reasons for entry abroad by firms is to seek to appropriate rents (e.g., Caves, 1971). Finally, management costs are also likely to be higher in MNE settings, since the transference of knowledge and maintaining continuity of association across borders must be at least as complex as doing so domestically.

When market (i.e., transaction plus bargaining) costs are low, exports become efficient as a mode of entry abroad. However, whether or not the firm chooses direct (i.e., own) or indirect sales channels will depend on whether or not its organization costs are high. When organization costs are high, the firm would have to contract its selling activity out through indirect sales channels; on the other hand, when organization costs are low, the firm would internalize its export sales through direct sales channels.

In summary, even if asset-specificity is held constant, as country risk varies by location of multinational activity, so will bargaining, influence and management costs. We

have argued earlier that particular combinations of these four types of cost will result in particular organizational forms. Thus, varying country risk will result in different organizational forms within the same firm across different locations, the result being differentiated entry strategies in different locations of foreign operations within the MNE. Consequently, the geographically dispersed mature MNE will resemble a network of differentiated subsidiaries than it would an undifferentiated hierarchy.

We summarize our arguments in Proposition 3A and 3B.

*Proposition 3A: When market costs are low and organization costs high in the location of foreign operations, the MNE is likely to choose exports with indirect sales channels as the mode of entry abroad; when market costs are low and organization costs low in the location of foreign operations, the MNE is likely to choose exports with direct sales channels as the mode of entry abroad.*

*Proposition 3B: When market costs are high and organization costs are low in the location of foreign operations, the MNE is likely to choose direct foreign investment as the mode of entry abroad; when market costs are high and organization costs high in the location of foreign operations, the MNE is likely to choose contractual modes of entry abroad.*

## IMPLICATIONS

One of the major challenges in developing a new typology is justifying its value-added to the research literature. We discuss six specific implications of our proposed framework, with a view to justify its value-added.

### *1. Clearer Demarcations of Organizational Types*

The traditional hierarchy-market continuum deals with the polar extremes, but interest in organizational forms has introduced terms such as networks (Thorelli, 1986; Powell, 1990), strategic alliances and joint ventures (Harrigan, 1988; Kogut, 1991), quasi-

firms (Eccles, 1981), quasi-integration (Blois, 1972), often without formal definitional criteria.<sup>10</sup> More importantly, while the hierarchy has been conceptualized as an efficient response to market failures from a TCE logic, there have been few attempts to articulate the forces underlying the emergence of intermediate forms (see Williamson, 1991 for an exception). For instance, Thorelli notes that networks lie *between* markets and hierarchies, while Powell notes that networks are *neither* markets and hierarchies. Systematic theorizing on organizational forms requires not only precise definitions but also clear demarcations among the dominant types. In this vein, our framework provides a basis to both define and distinguish among the four dominant types of organizational forms -- markets, hierarchies, intra-organizational networks and inter-organizational networks through an integration of four types of costs--transaction, market, bargaining and influence (see Table 1). We hope that future discussions and definitions of the organizational forms will be explicitly predicated on the underlying characteristics of these four types of cost.

## 2. Commonalities across Research Streams

Figure 2 summarizes how our framework provides a finer level of insights into organizational forms belonging to four common types, across three important streams of research in strategic management: vertical integration (Figure 2a), corporate diversification (Figure 2b), and MNE entry strategies (Figure 2c). Our summary argument is that we are likely to observe four basic types of organizational form as efficient responses to distinct combinations of the four types of cost in any activity that shapes the scope of the firm. Pure hierarchies would result when market costs are high and organizational costs are low and pure market forms would result when organizational costs are high and market costs are

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<sup>10</sup> A significant exception is Ouchi's (1980) notion of "clans": however, our concept of intra-organizational networks, characterized by embeddedness and non-formalized means of control is similar to the organizational type that Ouchi refers to as a clan.

low. Under the other two contexts, we are likely to observe mixed modes of governance characterized by inter- or intra-organizational network relationships.

(Insert Figure 2 About Here)

### 3. *Differential Insights?*

A complementary issue is whether differential insights can be obtained for predicting the organizational form from the proposed framework beyond the traditional transaction cost perspective that has dominated research on organizational forms. As our preceding discussion on the three examples highlights, there are strong reasons to critically assess the power of the received theory on organizational forms.

For instance, we examined how the research stream on corporate diversification might benefit from positioning management and influence costs as theoretical anchors, and how we can explain the MNE as a differentiated network by examining cross-national variances in bargaining, management, and influence costs, possibly arising from country risk. Past empirical approaches to understanding vertical integration and MNE entry strategies have generally sought to assess whether interfirm relationships conform to predictions from the TCE logic, with varying degrees of success. Given the difficulties in observing and measuring transaction costs, researchers have resorted to develop and test a set of linear hypotheses (mostly under *ceteris paribus* conditions), that relate the determinants of transaction costs (such as asset specificity, frequency of interactions and/or uncertainty) to the theorized governance mode.

Consider the case of vertical integration. For the most part, there has been consistent empirical support for broad theoretical propositions, but Masten et. al. (1991) argue that "such indirect tests are unable to distinguish whether observed patterns of organization

resulted from hypothesized changes in market transaction costs or from systematic, but as yet unexplored, variations in the costs incurred organizing production internally" (pp. 1-2) and that "claims that observed institutions minimize transaction costs have been easy to make and impossible to refute" (p. 4). Beyond the general criticisms of indirect approaches to empirical tests, Masten et. al. highlight the possibility that observed results could be due to other costs, more notably due to those components that we call here as "organization costs." To the extent that competing constructs (along our framework) can be explicitly included in the specification of the model, it may be possible to develop more direct tests of the determinants of vertical integration. Similar arguments apply to the empirical analysis of both corporate diversification and MNE entry strategies.

#### *4. Other Potential Areas of Application*

Beyond the three examples, our framework has the potential to offer systematic research insights into the study of joint ventures. Research efforts on joint ventures have been largely focussed on the reasons for such ventures either from a TCE perspective (e.g., Hennart, 1991) or an options perspective (e.g., Kogut, 1991), inductive frameworks (e.g., Borys and Jemison, 1989; Harrigan, 1988), and empirical assessments of effectiveness (e.g., McConnell and Nantell, 1985; Koh and Venkatraman, 1991). The theoretical reasons for forming joint ventures are clearly broader and more complex than can be explained from a TCE perspective. We believe that the other types of cost--bargaining, influence, and management--may provide powerful explanations for specific categories of joint venture that include, but are not limited to: minority equity investments, technology licensing, cooperative R&D, and marketing exchange. There is considerable scope for research in relation to various types of joint venture to be sharpened by the typology of four costs we propose.

### *5. From Conceptual Framework to Empirical Tests*

We recognize that conceptual frameworks are only partly useful unless they can be used as a basis to derive specific hypotheses that can be tested against empirical data. To the extent that our discussion and the propositions induce researchers to derive specific hypotheses that predict organizational forms based on a systematic specification across the four types of cost, our efforts would have been worthwhile. The empirical challenges lie in three areas: (i) to evaluate our general framework (Figure 1) as well as the specific frameworks (Figure 2) against the researchers' specific beliefs, conjectures, and research evidence; (ii) to derive operational measures from the constructs we identify; and (iii) to develop a set of feasible designs in order to verify the theoretical predictions.

Regarding the first issue, we believe we have been able to argue that our framework is consistent with theoretical perspectives in both institutional economics and organization and management research. Nevertheless, additional assessments would be welcome as they would add to the veracity and power of the framework. Regarding the second issue, the acceptance of TCE perspectives in organization and management research has led to the development of operational measures along a social science tradition to understand the empirical manifestations of transaction costs (e.g., Masten et. al. (1991); Walker and Weber (1984))--in other words, the theoretical power of TCE has been enhanced by the empirical power of organization and management research. We believe that the ideas relating to the four types of cost in this paper can be similarly enriched, and a link between theoretical constructs and empirical measures developed.

Regarding the third issue, we believe that a variety of research designs are plausible: these range from case studies that are able to document the complexity underlying the

selection of a particular governance form,<sup>11</sup> to those that assess the predictive validity of a set of variables that reflect our four dimensions (along a positivist social science tradition), within a sample of governance decisions. Essentially, we do not prematurely rule out any particular design as being inappropriate or inherently weak at this stage of early thinking in this area.

#### 6. *Organization Sciences as "Exporters" to Economics*

As we have noted above, organizational scientists have "imported" perspectives such as TCE that have traditionally been in the domain of research in institutional economics. Clearly, such importation has added value to our understanding of markets and hierarchies. However, we also noted that the economists' approach to the firm is one of "why do markets fail," rather than one of "are firms as natural as markets as means of effecting economic exchange," let alone that of "why do firms fail and markets arise." In this paper, we have attempted to provide some answers to the latter two questions, on the presumption that organizational science researchers have not felt (and we might add, justifiably) the need to rationalize or "invent" the existence of firm-like entities (see, for example, our quote from Chandler in footnote 1).

Economists (e.g., Milgrom and Roberts; Williamson in his recent writings) have begun to realize that the firm is more than just "hierarchy" (in the traditional TCE sense) and that it encompass a richer variety of forms. The attributes of this variety are fundamentally rooted in the organizational sciences. Just as economists have dimensionalized markets versus hierarchies, we contend that organizational scientists, based on their comparative advantage, should be exploring ways to dimensionalize forms

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<sup>11</sup> For example, such a case study could follow the logic of Allison's (1971) discussion of the decision-making process pertaining to the Cuban Missile Crisis in 1962.

such as inter- and intra-organizational networks with a view to *export* their insights to economists.

This would require the development of theories that *complement* (rather than substitute) what the economists have to offer (since, as the experience with application of TCE insights clearly shows, there is much of value to be imported from the economists). The development of such theories could go beyond arguments for existence (and empirical work that merely observes the existence) of particular organizational forms, and begin to explore the structure and governance of these non-traditional forms.

We view a framework such as the one developed above as an opportunity to offer a sister discipline and its practitioners a set of insights that are rooted in their own turf—hence our emphasis at the outset of using a set of behavioral and environmental assumptions, as well as goals of the firm that are consistent with the institutional economics viewpoint.

### CONCLUSION

Organizational and management researchers are confronted with several types of organizational form that are different from traditionally postulated ones, namely markets and hierarchies. While these traditional forms have been researched from (and usefully informed by) the TCE perspective, we have argued that this perspective is limited in its ability to explain emergent forms that have been variously conceptualized as hybrids, networks, clans, etc. We developed an integrative framework—under a set of behavioral and environmental assumptions that are consistent with the TCE logic—to explain organizational forms based on four types of cost, illustrated it with three important strategic management themes. The power of this framework will, of course, be determined by whether the intrinsic logic proposed above is borne out empirically. Our position is that, at a minimum, it provides a more comprehensive basis for developing finer *ex ante*



hypotheses, rather than looking for *ex post* rationalizations when the TCE logic is not supported. We hope that future research on organizational forms will be stimulated by this framework.

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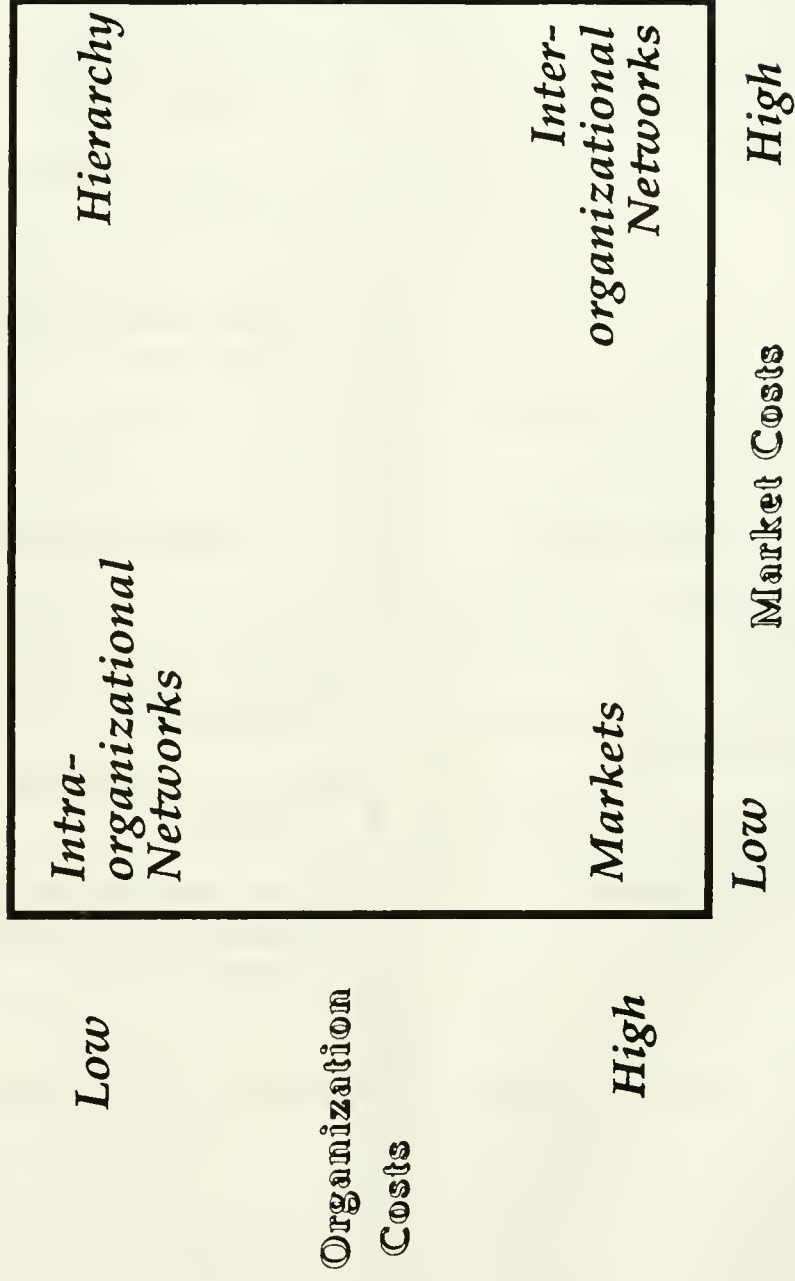
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**Table 1: Variables Influencing Market Costs and Organization Costs**

Market Costs	Organization Costs
<p align="center"><b>TRANSACTION COSTS</b></p> <ul style="list-style-type: none"> <li><input type="checkbox"/> Asset specificity</li> <li><input type="checkbox"/> Interaction frequency</li> <li><input type="checkbox"/> Uncertainty</li> </ul>	<p align="center"><b>INFLUENCE COSTS</b></p> <ul style="list-style-type: none"> <li><input type="checkbox"/> Rent-seeking behavior</li> <li><input type="checkbox"/> Reliance on information of interested parties</li> <li><input type="checkbox"/> Inefficient/inappropriate selective intervention</li> <li><input type="checkbox"/> Activities of low organization-wide importance but high distributional consequences</li> </ul>
+	+
<p align="center"><b>BARGAINING COSTS</b></p> <ul style="list-style-type: none"> <li><input type="checkbox"/> Outcome indeterminacy in bilateral monopoly</li> <li><input type="checkbox"/> Information acquisition and enforcement costs</li> <li><input type="checkbox"/> Bargainers' wages and delays</li> <li><input type="checkbox"/> Coordination Failures</li> </ul>	<p align="center"><b>MANAGEMENT COSTS</b></p> <ul style="list-style-type: none"> <li><input type="checkbox"/> Input costs convex in firm size</li> <li><input type="checkbox"/> Spatial distribution and transaction heterogeneity</li> <li><input type="checkbox"/> Suboptimal factor use as a function of firm size</li> <li><input type="checkbox"/> Costs associated with the creation, use and diffusion of intra-firm knowledge</li> </ul>

Figure 1: Our Framework



## Figure 2: Illustrating the Usefulness of Our Framework

Figure 2(A): Positioning Vertical Integration

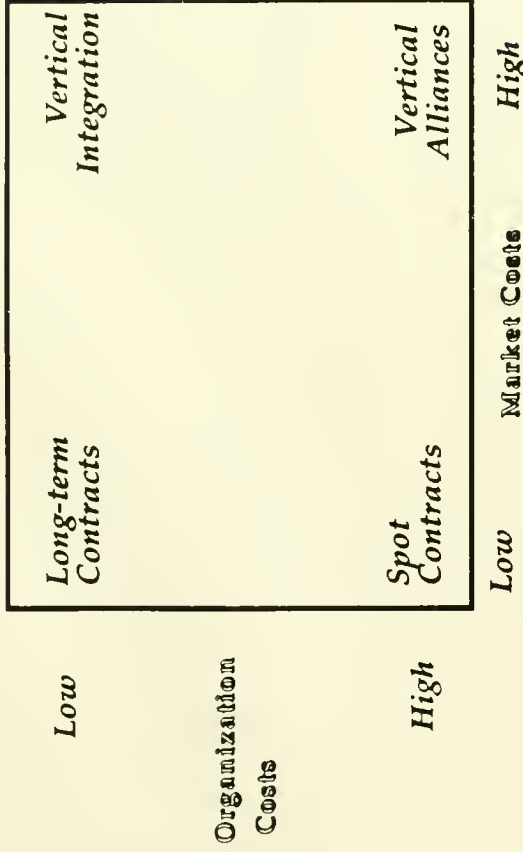


Figure 2(B): Positioning Corporate Diversification

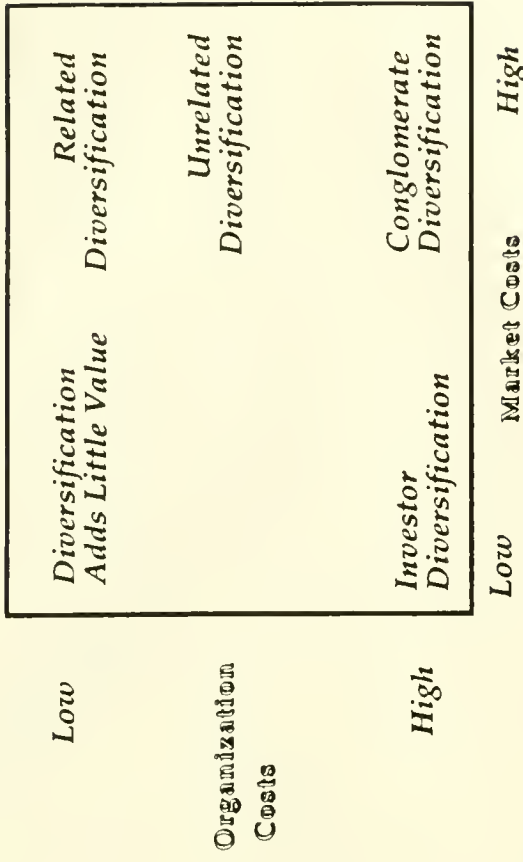
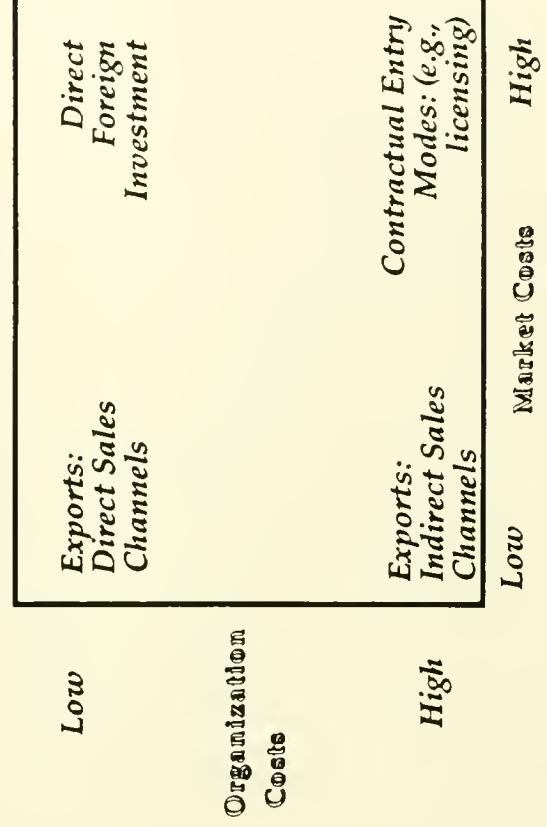


Figure 2(C): Positioning Multinational Entry Strategies



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